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Taxation on Corporate Restructuring（I）

New tax rules relating to the tax treatment of certain corporate restructuring transactions are expected to be finalized soon by the PRC Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT").

Under China's pre-2008 foreign enterprise income tax ("FEIT") regime, the SAT issued guidance on the tax treatment of corporate restructuring transactions, including *Guo Shui Fa [1997]*. No 71 ("Circular 71") and *Guo Shui Han Fa [1997].No 207* ("Notice 207"). Circular 71 provided detailed guidelines on the tax treatment of corporate restructuring transactions, including mergers, spin-offs, asset transfers and share restructurings. Notice 207 confirmed that a foreign investor could transfer its equity interest in a Chinese enterprise to a 100% related enterprise at cost, provided a commercial-purpose test could be satisfied. The guidance provided in Circular 71 and Notice 207 was interpreted by many foreign investors as indicating preferential tax policies under the FEIT regime.

In principle, however, the favorable tax treatment granted under Circular 71 and Notice 207 terminated once the Enterprise Income Tax Law ("EIT Law") became effective on January 1, 2008, unless further regulations are issued by SAT and MOF to maintain it. Such Implementation Rules, covering specific matters such as the taxation of corporate restructuring, are expected be issued soon. Enterprises are nearing the deadline to report their corporate restructurings in annual EIT filings and guidance is needed soon on the tax treatment of such transactions (such filings are generally due before the end of May, but there are slight difference in some places). Guidance is also necessary given the significant role that tax considerations play in the planning and structuring of potential corporate transactions.

In general, the EIT Laws provide that an enterprise that undergoes a corporate restructuring will realize gain or loss for tax purposes on the transfer of assets, and the tax basis of the assets will be determined according to the transaction values, unless otherwise prescribed in further regulations. The EIT Laws do not yet provide definitions of corporate restructuring transactions or the related tax results, but simply refer to regulations possibly promulgated by MOF and SAT.

While enterprises would like the final regulations to be issued as soon as possible, it is important that the Implementation Rules relating to the tax treatment of corporate restructurings cover all of the following matters:

(I) Detailed types of "Corporate Restructuring:" The scope of the Implementation Rules depends on the types of corporate restructuring transactions they govern. The final regulations should at least apply to the four kinds of transactions mentioned in Circular 71, i.e., mergers, spin-offs, share restructurings and asset transfers. Additionally, guidance on equity acquisitions described in Notice 207 would be welcome.

(II) Special tax policies: The Implementation Rules should provide guidance on any favorable tax treatment for enterprises, not only with respect to inbound transactions but for cross-boarder transactions as well.

(III) Retroactive effect: The Implementation Rules would preferably be effective retroactive to January 1, 2008 to align with the effective date of the EIT Laws.

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